

# **Fiduciary Duties from Ordinary Course, into Distress and Insolvency, and Through Bankruptcy**

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# Fiduciary Duties from Ordinary Course, into Distress and Insolvency, and through Bankruptcy

May 14, 2015





## Solvency: Ordinary Course Duties



### Basic Fiduciary Duties

## Basic Fiduciary Duties:

- Care
- Loyalty
- Good Faith



General Types of Breaches

## Breaches of These Duties Can Result From:

- Nonfeasance – *e.g.*, failure to supervise or monitor
- Malfeasance – *e.g.*, putting personal interest ahead of the corporation's interests



Beneficiaries of Basic Fiduciary Duties

## To Whom Are the Basic Duties Owed?

- The Corporation
- Shareholders



Enforcement of Fiduciary Duties

- Enforcement of Adherence to Fiduciary Duties Can Be By Shareholder Derivative Action
- Creditors Lack Standing to Bring Derivative Claims and Are Expected to Protect Their Rights Principally Through Contract

*See, e.g., Big Lots Stores Inc. v. Bain Capital Fund VII LLC, 922 A.2d 1169, 1180 (Del. Ch. 2006).*



Protection for Officers and Directors: Business Judgment Rule

- Where a director acts with diligence and in good faith, absent conflict of interest, the business judgment rule typically protects him/her from liability for breach of duties.
- In other words, where a director is confident that a company is solvent and he/she is attentive and disinterested, he/she is meant to have wide latitude, even if that entails supporting a risky bet.

*See Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000).*



Greater Scrutiny Absent Disinterestedness

- When a court has reason to question the complete disinterestedness of directors, more exacting scrutiny applies to the review of decisions.

*See, e.g., Paramount Commc'ns Inc. v. QVC Network, Inc.*, 637 A.2d 34, 43 (Del. 1994) (best price on sale of control test); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 958 (Del. 1985) (reasonableness and proportionality of takeover resistance test); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) (entire fairness test).



Uncertainty with Respect to the What or Who Increases Exposure

- Where either of the two general questions discussed above—namely, what the duties are and to whom they are owed—become less clear-cut, directors have more exposure and arguably need more professional advice.
- A transaction, especially if risky, can be seen as “Hail Mary” for the benefit of shareholders and at the expense of creditors.

*See, e.g., Prod. Res. Group v. NCT Group*, 863 A.2d 772, 790 n.57 (Del. Ch. 2004).



## Zone of Insolvency:



### Determination of Insolvency

## Two tests for insolvency:

- Balance Sheet Test
- Cash Flow Test

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The Vicinity of Insolvency

In *Credit Lyonnais*, the Delaware Chancery Court noted that directors of a solvent corporation operating in the “vicinity of insolvency” owe fiduciary duties to the corporation not only for the benefit of shareholders, but also for the benefit of the community of interests that the corporation represents, to include creditors.

See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, No. CIV. A. 12150, 1991 WL 277613, at \*34 n. 55 (Del. Ch. Dec. 30, 1991).

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Identifying the Zone of Insolvency

The Delaware Courts have not set forth a precise definition of what constitutes the zone of insolvency.

See *Credit Lyonnais*, 1991 WL 277613, at \*34; *Prod. Res. Grp., L.L.C. v. NCT Grp., Inc.*, 863 A.2d 772, 789 n. 56 (Del. Ch. 2004) (describing the difficulties presented in identifying the zone of insolvency).

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Fiduciary Duties to Creditors

Some courts found *Credit Lyonnais* supported the proposition that directors of corporations in the “zone of insolvency” owe fiduciary duties directly to creditors of the corporation.

See, e.g., *In re NCS Healthcare, Inc., S'holders Litig.*, 825 A.2d 240, 256 (Del. Ch. 2002) (“as directors of a corporation in the ‘zone of insolvency,’ the NCS board members also owe fiduciary duties to the Company’s creditors”), *rev’d sub nom., Omni Care, Inc. v. NCS Healthcare, Inc.*, 822 A.2d 397 (Del. 2002); *In re Buckhead Am. Corp.*, 178 B.R. 956, 968-69 (D. Del. 1994) (finding that company was within the zone of insolvency such that creditors had standing); *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 195 (Del. Ch. 2006) (noting that “the jurisprudence refers to the directors as owing fiduciary duties to the firm and its creditors”); *Weaver v. Kellogg*, 216 B.R. 563, 582–84 (S.D. Tex. 1997) (holding that directors may owe fiduciary duties to creditors if the corporation was in the “vicinity of insolvency”).

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Clarification from the Delaware Supreme Court - *Gheewalla*

- Directors of corporations in the “zone of insolvency” do not owe fiduciary duties to creditors of the corporation.
- Creditors do not have standing to bring a *direct* claim against directors when a corporation is in the “zone of insolvency.”

See *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) (“When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.”).

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Relevancy of the Zone of Insolvency after *Gheewalla*

- *Gheewalla* did not eliminate the “zone of insolvency” concept.
- The Court did not address whether a Creditor could bring a *derivative* action when the corporation is in the zone of insolvency.

See *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, No. CIV.A. 1456-N, 2006 WL 2588971, at \*11 n. 107 (Del. Ch. Sept. 1, 2006), *aff’d*, 930 A.2d 92 (Del. 2007).

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The Zone of Insolvency Outside of Delaware

- California
  - Directors have no duties to creditors when the corporation is in the zone of insolvency. *Berg & Berg Enters., LLC v. Boyle*, 178 Cal. App. 4th 1020, 1041 (Cal. Ct. App. 2009).
- Florida
  - Fiduciary duties of officers and directors extend to the creditors of a corporation when the corporation becomes insolvent or is in the vicinity of insolvency. *In re Trafford Distrib. Ctr., Inc.*, 431 B.R. 263, 290 (Bankr. S.D. Fla. 2010).
- New York
  - “Under New York law, corporate officers and directors owe a fiduciary duty to preserve corporate assets for the benefit of creditors once the company is actually insolvent, but not while the company is merely operating in the zone of insolvency.” *Alpha Capital Anstalt v. New Generation Biofuels, Inc.*, No. 13-CV-5586 VEC, 2014 WL 6466994, at \*18 (S.D.N.Y. Nov. 18, 2014) (internal citations omitted).

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## Insolvency:



### Fiduciary Duties Expand

- When a corporation is insolvent, its creditors take the place of its shareholders as the residual beneficiaries of any increase in value.
- Although creditors of an insolvent corporation do not have a right to assert direct claims against directors for breach of fiduciary duties, they have standing to bring such claims on behalf of the corporation.

*See N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101-03 (Del. 2007).

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Directors Still Benefit from the Business Judgment Rule

- In *Quadrant*, creditors had standing to bring derivative suits because the corporation was *insolvent*.
- The Business Judgment Rule applied to the directors' decision to drastically alter the corporation's investment strategy.
- Deciding to continue making payments on promissory note held by controller was a transfer of value which directors would have to prove was entirely fair.

See *Quadrant Structured Prods. Co. v. Vertin*, 102 A.3d 155 (Del. Ch. 2014).

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Duties of Managers of Limited Liability Companies

- Creditors of insolvent Delaware Limited Liability Companies do not have standing to assert claims against the Company's managers.
- In *Bax*, the Delaware Supreme Court found the plain language of the Delaware Limited Liability Act exclusively limits derivative standing to members or assignees of a membership interest in the Company.

See *CML V, LLC v. Bax*, 28 A.3d 1037, 1043 (Del. 2011).

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Bankruptcy:

**May 14, 2015 ABI Conference  
Panel on Fiduciary Duties in Chapter 11  
The Rights Offering as Illustration**

**Sabin Willett  
Amelia C. Joiner  
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March 27, 2015**

Today's panel explores the fiduciary duties of boards of directors in chapter 11. Courts have ruled that boards owe such duties to creditors. *In re Ionosphere Clubs, Inc.*, 113 B.R. 164, 169 (Bankr. S.D.N.Y. 1990) ("A debtor-in-possession must act as a 'fiduciary of his creditors'"); *In re Eastman Kodak Co.*, 2012 WL 2501071, at \*2 (Bankr. S.D.N.Y. June 28, 2012) ("It is recognized that the debtor in possession in a chapter 11 case has fiduciary duties to the creditors"); *In re Count Liberty, LLC*, 370 B.R. 259, 276 (Bankr. C.D. Cal. 2007) ("[T]he debtor in possession's fiduciary obligations to the corporation, its creditors and shareholders, fall upon the officers and directors."); *compare N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007) (outside of chapter 11, board of insolvent corporation owes no fiduciary duty to creditors). Because state law controls corporate governance in chapter 11, fiduciary duties owed to shareholders persist in chapter 11 as well. *See Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 355 (1985) (the fiduciary duty "runs to shareholders as well as creditors"); *Eastman Kodak*, at \*2 ("The insolvency of a company does not absolve the board of its fiduciary duty to the shareholders.").

Is there a tension between fiduciary duties owed simultaneously to shareholders and creditors? This note explores the potential for conflict illustrated by one tool in the reorganization toolbox—the rights offering in chapter 11. "Rights offering" plans are plans of reorganization built around an arrangement in which a class of stakeholders (generally, bondholders) is offered the "right" to contribute new money in exchange for shares of the reorganized debtor.<sup>1</sup> Generally these arrangements are dressed by parties and even courts in beatific robes. Commentators often hymn the facility with which they raise new capital "needed" by the debtor for reorganization. *See, e.g.*, Clifton R. Jessup Jr., "OSG Bankruptcy Highlights Usefulness of Rights Offering," Law360 (June 2, 2014) (accessible at [www.gtlaw.com/News-Events/Publications/Published-Articles](http://www.gtlaw.com/News-Events/Publications/Published-Articles)).

Typically, an *ad hoc* committee of bondholders receives nonpublic financial information, and then underwrites the "offering," in which a sub-class of creditors (made up of institutional

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<sup>1</sup> The *Lyondell* case presented the less typical example: a rights offering underwritten by sponsors that included both an affiliate of the debtor's main equity holder, and a party that bought debt in the secondary market. More typical are cases in which a class of bondholders underwrites an offering to qualified unsecured creditors. *See In re Visteon Corp.*, No. 09-11786 (CSS) (Bankr. D. Del.); *In re Tronox Inc.*, No. 09-10156 (ALG) (Bankr. S.D.N.Y.); *In re Eastman Kodak Co.*, No. 12-10202 (ALG) (Bankr. S.D.N.Y.); *In re MPM Silicones, LLC*, No. 14-22503 (RDD) (Bankr. S.D.N.Y.).

holders) is offered rights to purchase new equity securities in the reorganized debtor.<sup>2</sup> This group backstops the offering, earning a handsome fee for an underwriting “service” that seems never to be called upon. (The deals generally are oversubscribed. Why? Onward, gentle reader).

Liquidity of the reorganization shares often is a prime objective of the sponsors, which may lead to restrictions on those creditors who may participate in the offering. *See, e.g., In re Dana Corp.*, No. 06-10354 (Bankr. S.D.N.Y. Oct. 23, 2007), ECF No. 6669 (restricting participation in offering to “qualified” buyers). These limitations in turn sometimes generate objections under 11 U.S.C. § 1123(a)(4) (requiring the same treatment for each member of a class). The plans provide that trade and small creditors are separately classified, and cashed out with the new money raised by the rights, often at a discount to the face of their claims. Should the reorganization shares appreciate in value, they will enjoy none of the upside.

The debtor’s disclosure statement proffers a reorganization enterprise value insufficient to reach holders of pre-petition equity, driving the rights-favorable pricing. On the effective date, the rights purchasers take ownership of the debtor. The debtor’s management often retain their positions and a minority equity stake. The enterprise continues; previously over-levered, the debtor emerges from bankruptcy with greatly reduced debt.

So everybody wins, right? Whenever a “win-win situation” is proposed in a bankruptcy courtroom, we can be pretty certain that the class of actual winners includes the proponent. Beyond that, things are less clear. In a rights offering, the real “right”—being distributed to group of quasi-insiders—is the right to buy the debtor on the basis of nonpublic information, and close without the nuisance of competition. *See, e.g., In re J.L. French Automotive Castings, Inc.*, No. 06-10119 (Bankr. D. Del.) (objection of creditors’ committee to rights offering’s lack of market testing leads to its removal from plan). This explains why the underwriting feature is rarely necessary. The deals are generally oversubscribed because they involve two discounts. The first is express—the rights offerors are given, unaccountably, a discount from the stated enterprise value, without any showing that the discount is necessary to encourage their participation. The second discount is that which invariably accrues where sophisticated, knowledgeable, self-interested institutions are permitted to purchase without competition. The stated enterprise value itself is understated.

Is the new money “necessary” to reorganization? Generally it doesn’t furnish working capital that couldn’t be provided by an exit loan facility, or provide the only source of funds for administrative expenses. Usually the debtor has choices. It could simply distribute securities to its creditors (senior secured notes to its secured creditors, and reorganization shares to unsecured

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<sup>2</sup> The securities law aspects of rights offerings are complex; depending on whether the recipient of the right is simply an unsecured creditor receiving the right in consideration of its claim, a backstop party receiving it as underwriting compensation, or an institution that meets certain “size and sophistication” tests, different regimes will govern whether securities must be registered, and how and when they may be resold. To achieve maximum liquidity for themselves, sponsors often navigate this terrain by structuring deals in a manner that limits participation to “qualified institutional buyers” under Rule 144A, effectively excluding smaller creditors, or to those who qualify under Rule 144. *See, e.g., In re Wash. Mut., Inc.*, 444 B.R. 314 (Bankr. D. Del. 2011); *In re Harry & David Holdings, Inc.*, No. 11-10884 (Bankr. D. Del.), ECF No. 503; *In re Dana Corp.*, No. 06-10354 (Bankr. S.D.N.Y.), ECF No. 6669.



creditors) under section 1145, saving itself the underwriting fees. That is, the debtor “needs” the cash not in a chapter 11, but rather in a circular sense: if the debtor is to grant all of its reorganization shares to a favored group of prior debt holders, it needs cash to dispense with other creditors who might raise a fuss.

Thus a rights offering is not so much a capital-raising effort as a sale. The debtor is being sold to an investor group that will not be subject to overbids. And the buyers who participate really are *buyers*. The “creditors” are quite unlikely to be historical creditors at all—they generally are secondary debt purchasers, who have figured out that the way to buy a company in chapter 11 is not to bid for it under section 363, but to buy its debt at a discount and then control the sale through a rights offering.

### *Tronox*

The reorganization of Tronox, Inc. illustrates.<sup>3</sup> Tronox owned and operated titanium dioxide plants, manufacturing the key commodity chemical used in the manufacture of white paint and other commercial whiteners. It filed its chapter 11 petition in the Southern District of New York on January 12, 2009, with outstanding indebtedness consisting of \$212 million in senior secured credit, \$350 million (principal) of bonds, and a highly-disputed amount of contingent environmental liability. The company emerged—virtually debt-free—on February 14, 2011. Although the cause of the filing was hotly disputed, it was not disputed that, at emergence, Tronox was essentially the same enterprise that it had been on filing two years earlier: a number of titanium dioxide plants around the world, manufacturing essentially the same commodity products.

Tronox was a “spin off.” The company was formed by Kerr-McGee Corp. and then sold to the public in an IPO in 2005. Kerr-McGee created Tronox as a stand-alone newco, transferring to it, in exchange for the IPO proceeds, the equity of subsidiary companies which owned the titanium dioxide plants, and were directly and contingently liable for environmental liabilities incurred over previous decades of manufacturing. The environmental dispute lay at the center of a fraudulent transfer suit that followed the chapter 11 proceedings. The debtor, and later a trust created by its plan, alleged that Kerr-McGee had, in 2002, separated valuable oil and gas businesses from the companies liable on legacy environmental debts, and then spun off the separated businesses (which housed the titanium dioxide business and legacy liabilities) to Tronox in 2005.

All of the environmental matters were disputed, and the litigation was later settled, after an adjudication by the bankruptcy court that the separation was a fraudulent transfer. What matters for present purposes is that, on the filing date, in addition to the bond and secured debt, Tronox had some quantum of pre-petition environmental and tort claims, variously estimated by the parties’ expert witnesses at trial from approximately \$390 million (the defense’s contention) to approximately \$2 billion (the amounts to which plaintiff opined). The court ultimately valued the liabilities at \$1.27 billion.

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<sup>3</sup> *In re Tronox, Inc.*, No. 09-10156 (ALG) (Bankr. S.D.N.Y.). *Tronox* is best known for its fraudulent transfer litigation, a fracas in which the authors participated in the defense at trial. Most of the disputes raised in that massive litigation—now settled—are not germane to this paper.

Tronox's 2009 filing followed on the heels of the 2008 global financial crisis. In 2010, an *ad hoc* bondholders' committee proposed that through a trust mechanism, Tronox's reorganization plan leave most of the proceeds of the fraudulent transfer litigation to environmental and tort creditors. The bondholders would raise new money in a rights offering, use it to extinguish remaining trade claims and senior debt, and in return take the equity in the largely debt-free enterprise—the TiO<sub>2</sub> business, shorn of environmental hair [ ] that would emerge from chapter 11. The debtor embraced the bondholders' sponsorship of this rights offering, and filed a disclosure statement in September, 2010, estimating the enterprise value of the reorganized debtor at about \$1.06 billion, a figure just small enough to wipe out shareholder value.<sup>4</sup>

The plan was confirmed late in 2010, and became effective in mid-February, 2011. On the effective date, something remarkable happened. Reorganization shares were distributed to the bondholders, and traded on the market. But instead of demonstrating enterprise value in the range of \$1 billion, as projected by the November, 2010 disclosure statement, the share prices on the effective date showed enterprise value of approximately \$2.3 billion.<sup>5</sup> After adjusting for the fees paid to the underwriters (in the form of shares) each bondholder received, for a dollar's worth of unsecured claim, shares of stock worth \$3.54 in cash. Many did sell. More than \$1 billion in enterprise value was essentially wasted in overpaying pre-petition creditors: close to the amount at which the Court would later value the contingent environmental claims.

This happened because the debtor's disclosure statement profoundly understated the emergence value, a fact made possible by the rights offering itself. Because there was no market test, a group of sophisticated unsecured creditors was permitted to buy the company for a song.

### *The Board*

Consider then, the fiduciary duties of Tronox's board in chapter 11. What did it mean in that case to say that the board owed fiduciary duties both to Tronox's creditors and shareholders?

We should first be wary of hindsight. When Tronox filed, the world was an uncertain place. Markets were in a shambles. The creditor group was clamorous and sophisticated, and there was great fear of further erosion of values. Bondholders threatened a plan contest if their wants were not met. Without the new capital raise, the debtor would have had to propose reorganized notes for its institutional creditors, which might have led to a cram-down contest. Such a contest would have increased the debtor's administrative burden, and acted as a drag on the revenue generation Tronox hoped to achieve once it exited chapter 11. From the perspective of the enterprise itself, the rights offering would have the "advantage" that any sale has—it would de-lever the company, giving it more flexibility for the future. If the board owed a fiduciary duty to its "creditors," was that sufficient reason to support the rights' offering?

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<sup>4</sup> Shareholders sought, but were unable to obtain approval of an equity committee. After negotiation, they ultimately received warrants.

<sup>5</sup> The sum is calculated from the public share price on the effective date of approximately \$125.

Perhaps. But on the other hand, the plan wasn't confirmed until late 2010, by which time the company's operations had stabilized. The debtor didn't "need" new capital in any operating sense. (It departed chapter 11 with a mall exit facility, and little need to draw). The rights offering device imposed on the debtor significant fees (distributed in the form of shares) that would not otherwise have been necessary. It lacked any market test, and risked the massive waste of enterprise value that in fact occurred: as much as \$1 billion dollars of value that might have been enjoyed by environmental creditors or equity holders. In an environment where the buyer is already a creditor, a sale in chapter 11 is unlikely to realize equity value absent competition.

Certainly the bankruptcy code would have permitted a different plan in *Tronox*. The debtor might have issued to its bondholders restructured notes, valued at 100 cents, plus interest, and still had enterprise value well in excess of \$1 billion. Given the environmental creditors' demonstrated willingness to accept trust interests in the proceeds of the fraudulent transfer claim as their sole distribution, Tronox would then have had more than \$1 billion in value for its prepetition equity holders. There was no need to cash out anyone. The one thing that the bankruptcy code did not require Tronox to do was to overpay unsecured creditors by more than \$1 billion.

Imagine these scenarios:

1. In *Tronox*, an equity holder files an objection to the plan's grant of releases to the board. She argues that the board owed fiduciary duties to her, that she has not consented to a release, that the board permitted a creditor group to take control without any competitive mechanism, and that, on emergence, \$1 billion of enterprise value, which would otherwise have gone to equity, was lost.

2. In a *Tronox*-like case, with a rights offering that wastes \$1 billion of enterprise value, the fulcrum security remains the unsecured debt. The unsecured creditors accept the plan, but a hold-out bondholder objects to the releases in the plan, arguing that the board owed him, as a creditor, a fiduciary duty, could simply have proposed a debt-for-equity conversion, and that its failure to do so wasted \$1 billion of enterprise value and unnecessary fees.

In each case, can the objector argue that the board members owe to him personally a fiduciary duty, that the duty was breached by approving a sale mechanism that precluded competition, and that it was improper for the plan to erase a claim for breach of that duty? Can either objector proceed derivatively, arguing that the debtor was not adequately protected (say, by an independent committee approving the rights offering), and thus that the plan's extra-statutory releases ought to be disregarded? Chapter 11 depends on stakeholder democracy, *see* 11 U.S.C. § 1104(b) (creditor selection of chapter 11 trustee); § 1126(c) (plan voting), and permitting holdouts to bring suits of this kind arguably would be destructive of that franchise. Yet majoritarian concepts generally have no place in measuring fiduciary duties. *See, e.g., Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (cash-out merger that squeezes out minority shareholders breaches board's duty of loyalty). For example, in the somewhat analogous situation of merger cases, Delaware law recognizes that a derivative plaintiff's standing cannot be destroyed by the loss of a share interest in a merger, where the merger itself is the subject of attack. *See Lewis v. Anderson*, 477 A.2d 1040, 1046 n.10 (Del. 1984).

In *In re Perry Koplik & Sons, Inc.*, 476 B.R. 746 (Bankr. S.D.N.Y. 2012), the court recommended entry of judgment on state-law fiduciary-duty claims against two directors (and senior officers) of a closely-held New York corporation. Concluding that New York courts would likely follow Delaware jurisprudence as to fiduciary duties in insolvency, the court held that defendants had fiduciary duties “to the Debtor,” including “a duty of loyalty to the corporations they serve.” *Id.* at 796. The court reasoned that the solvency/insolvency “distinction affects only the persons or entities who may sue derivatively on behalf of the debtor.” *Id.* at 796-97:

Here, of course, the solvency-insolvency distinction is academic because [the directors] without dispute, owed fiduciary duties to the Debtor, at all relevant times. ... The Trustee could (and did) assert, on behalf of the Debtor, claims based on alleged breaches of those fiduciary duties ... for the benefit of all of [the Debtor’s] stakeholders.... Creditors and other stakeholders ... will simply share in available assets in accordance with their normal priorities.

*Id.* at 797. The court observed, “It would at least normally be true that officers and directors of an enterprise that was insolvent or in the zone of insolvency couldn’t properly gamble the farm to get stockholders back into the money. But that would be true not because the officers and directors owe a fiduciary duty to creditors as such, but rather because such would be irresponsible for the *enterprise*.” *Id.* at n. 274 (emphasis in original); *see also* Sabin Willett, “Gheewalla and the Directors’ Dilemma,” 64 *The Business Lawyer* 1087, 1093-94 (August 2009) (arguing that the board of an insolvent enterprise exercises its fiduciary duty of care by discounting each available option for risk, and choosing the result that maximizes enterprise value, so that, for example, a sale that wipes out equity value may meet the fiduciary duty of care by appearing to be the enterprise value-maximizing option).

Thus one way to rationalize duties owed simultaneously to both equity and creditors is to approach the problem as Judge Gerber did in *Perry Koplik*. The fiduciary duty of care in a reorganizing chapter 11 is thought of as a duty owed to neither constituency *per se*, but rather, to the enterprise as a whole. The duty is to take prudent steps to maximize enterprise value. *See Prod. Res. Grp., L.L.C. v. NCT Grp., Inc.*, 863 A.2d 772, 787-88 (Del. Ch. 2004). Each constituency—equity and creditors—would have standing to enforce that duty. *See N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d at 101-02. Still, the thesis that in chapter 11 the duty is owed only to the debtor (and thus must be enforced only by the Debtor, or derivatively on its behalf) may be challenged by those citing the many authorities that recite that the trustee, or debtor (and by extension the debtor’s board) owe fiduciary duties to creditors, and to shareholders. (The court itself noted many authorities that phrase the duties in those terms. *See* 476 B.R. at 796 & nn. 267-70). A court reading literally the many cases that speak of the duty running directly to both shareholders and creditors might uphold a stakeholder’s direct challenge to a rights offering, or other transaction with an obvious structural flaw such as the absence of competition.

# Fiduciary Duties in Chapter 11

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**Richard G. Mason**

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# Fiduciary Duties in Chapter 11

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## **Board of Directors is fiduciary for all stakeholders**

- Responsible for maximizing value of estate
- Must navigate potentially competing interests of:
  - △ secured creditors
  - △ unsecured creditors
  - △ equity holders
  - △ other interested parties (e.g., unions, customers, regulators)

# Fiduciary Duties in Chapter 11

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**Board decisions are reviewed under same standards as outside Chapter 11**

- Business judgment
- Entire fairness

**But in Chapter 11 the Board's decisions might be subject to oversight in areas in which, outside of bankruptcy, no court is involved**

- Compensation (severance and retention)
- Settlements (9019 review)
- Releases

**And the scrutiny can be far more intense and less deferential**

- Bankruptcy Court is forum for “real-time” review
- Decisions can be challenged by:
  - △ economic stakeholders (ad hoc committees)
  - △ official committees (co-fiduciaries)
  - △ government officials (United States Trustee)

# Fiduciary Duties in Chapter 11

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## **Potential liability for directors is usually low**

- Bankruptcy Court reviews and approves/disapproves non-ordinary course action before it is taken
- Directors usually released/exculpated in plan of reorganization for post-petition conduct

## **But directors must nevertheless be diligent in overseeing the debtor**

- Reputation
- Minimize or avoid public second-guessing of decisions
- Potential litigation if debtor collapses (Chapter 7 trustee)



# Fiduciary Duties in Chapter 11

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## Three areas in which fiduciary issues can arise

- Appointment of equity committee
- Restructuring Support Agreement
- Conflicts between or among subsidiary-debtors and debtor-parent

# Fiduciary Duties in Chapter 11

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## Appointment of equity committee

- Not warranted if Debtor is “hopelessly insolvent.”
  - △ How and when measured?
  - △ Does this mean Board no longer has fiduciary duty to shareholders?
- Board can “adequately represent” shareholders.
  - △ True in every case?
  - △ Does this put Board in conflict with creditors?

# Fiduciary Duties in Chapter 11

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## **Restructuring Support Agreement (RSA)**

- Binds creditors but not Debtor (fiduciary-out)
- Creditors often require Debtor to assume RSA
- Forces a mini-trial on plan of reorganization (Plan)
- What is the standard for scrutinizing Board decision to enter into RSA? Good faith? Business judgment? Entire fairness?

# Fiduciary Duties in Chapter 11

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## What if estates have claims against each other?

- Examples: tax claims; allocation of corporate overhead; intercompany loans/advances
- Who analyzes claims and determines whether to bring or settle them? Disinterested directors?
- What about Plan/strategy that affects subsidiaries differently?